Defying Conventional Wisdom

January 5, 2006

The performance of the global economy and international financial markets continues to be exemplary and in some ways defies conventional wisdom. Despite higher energy costs and unprecedented exogenous events, global economic growth remains above trend and again appears to be strengthening. This expansion is being accompanied by modest core inflation, low long-term interest rates and a surprisingly strong dollar. Such fundamental factors are laying the base for a solid economic cycle, strong business profitability and the prospect of an end to monetary tightening. In such an environment continued stock price appreciation can be expected.

The U.S. Economy

No matter where you look, news on the U.S. economy is good. Growth, as reported by the Bureau of Economic Analysis, averaged 4.3% so far in 2005. Inflation — despite higher energy prices — was subdued. The employment picture improved. The U.S. dollar flexed its muscles, rebounding nearly 13% in 2005 against a basket of six currencies of our major trading partners. Home values have risen more than 15% over the prior year. Retailers enjoyed a strong holiday selling season. If the U.S. economy were a football team, it would be heading to the Super Bowl with offense, defense and special teams rated at the top of their prospective specialties.

The U.S. economy has entered its fifth year of expansion with few signs of weakness. Real GDP increased at a 4.3% annual rate in the third quarter --the best growth rate since the first quarter of 2004. The July-September economy was the 10th straight quarter of growth above 3.0% -- the most consistent string of quarterly growth since 1983-86. The most recent GDP report also showed corporate profits up 17% year-over-year. While some 90% of the S&P 500 firms have reported as of this writing, the GDP report brought the first estimate from the Commerce Department of aggregate corporate profits. Losses from the Hurricanes Katrina and Rita are estimated to have reduced these profits by roughly $150 billion (annual rate), reflecting net benefits paid by U.S. insurers and uninsured losses of corporate property. (These losses were not all that dissimilar in magnitude to the losses produced by Hurricanes Charley, Frances, Ivan and Jeanne in the third quarter of 2004.) On a year-over-year basis, profits from current production were 17% ahead of the year-earlier rate. Net cash flow saw an 11% annual rate of increase in the quarter (+8% year-to-year). In addition, corporate dividends were 9% higher in the quarter than they were one year earlier. So, even with dividend payouts, companies are flush with cash to use for cap-ex spending. Indeed, the latest Flow of Funds data showed that the financing gap, the excess of internal company funds over cap-ex spending, widened to a record $198 billion!

Inflation was well behaved during the quarter given its erratic movements between 2.5% and 4.5% during the past year. These movements were due largely to the monthly gyrations of the energy component. Inflation rose particularly sharply on the back of oil and natural gas price increases associated with Hurricane Katrina—but then stabilized and has since decelerated. Core inflation, that excludes food as well as energy, bottomed at 1.1% in late 2003, moved higher through the spring of this year and then stabilized at around 2%. Inflation is generally quiescent and the market looks for it to stay that way.

Remember the 2004 debate over the "jobless recovery" and "outsourcing"? Here's the reality: the great American jobs machine has averaged a net increase of nearly 200,000 new jobs a month this year. Some 4.5 million more Americans are working today than in May of 2003, before the Bush investment tax cuts. The employment expansion in financial services, software design, medical technology and many other growth industries dwarfs the smaller job losses in the domestic auto industry.

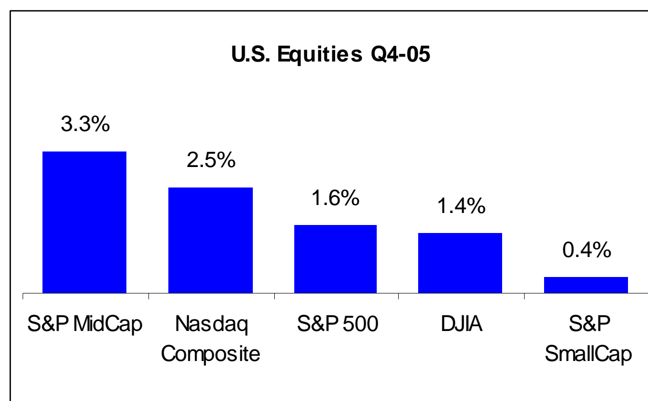
Even many of the widely publicized lost jobs at Delphi and General Motors are silently offset by the tens of thousands of Americans employed at new domestic plants built by multinational companies like Honda and Toyota of North America. This job growth has been accompanied from 2001 to 2005 with the best rate of labor productivity over any four-year period since the Labor Department started tracking this statistic. This productivity revolution augurs well for higher wages in 2006. Real hourly wages are up 1.1% versus the previous business cycle peak in early 2001. Workers are now earning more per hour in real terms than they did at the height of the 1990s expansion.

The real gains for families have been in the value of their assets. In 2005 Americans owned an all-time high level of wealth (mostly housing and stocks), valued at $50 trillion, according to the Federal Reserve. Median household net worth is now estimated at more than $100,000. Rather than being overloaded with credit card bills, the truth is that Americans' assets are rising in value faster than they are taking on debt. And it's not just the rich who are getting richer. It's the tens of millions in the middle class who could afford to visit malls this Christmas shopping season and purchase cell phones, DVD players, $2,500 flat-panel HDTVs, $400 Xboxes, digital cameras, pink iPods and laptop computers. This buying spree isn't the behavior of people who are feeling poorer.

With low inflation, robust output growth, and strong profits growth fueling cap-ex spending, the economy is in a sweet spot.

U.S. Financial Markets

Investors have come to expect a stock market rally in the fourth quarter, and in November they appear to have delivered on their own expectations. Just when it looked like 2005 would have to be chalked up as an ignominious year for the economy and stock market, consumer confidence rebounded and stock prices rallied 7.8% to new highs off the October lows. This move constitutes the best such rally since – as it happens – the October to December period a year ago. Unfortunately, December failed to deliver the much-anticipated returns of yesteryear and the quarter ended with stock prices up only 1.6%.



The S&P 500 index returned 4.9% for the past twelve months, sub-par by normal standards but not bad considering the many obstacles that OPEC and Mother Nature threw at investors in 2005. This year's 12% high/low trading range for the S&P 500 is one of the smallest ranges since the inception of the S&P Composite in 1926: only the early 1990s – specifically 1992, 1993 and 1994 – had narrower trading ranges. Stock and bond volatility was also remarkably subdued, with the VIX and MOVE indexes near multi-year lows.

Lower-quality stocks fared considerably better for both the quarter and year compared to the largest companies while generally highest-quality stocks were ignored. In fact, the largest 100 stocks in the S&P 500 rose less than 3.5% this year. General Motors and Ford Motor lost close to half their value as the industry struggled with flagging sales and rising pension and medical costs. Even stalwart household names such as Dell and Avon Products fell by 25%. Mid-capitalization stocks as measured by the S&P Mid Cap 400 index continued to shine and rose 3.3% during the fourth quarter bringing full-year 2005 gains to 12.6%. The NASDAQ Composite experienced a year-end rally and rose 2.5% for the last three months but the index only gained 1.4% for 2005. Conversely, small-capitalization stocks suffered during the fourth quarter returning only 0.4%, but finishing out the year with a 7.7% gain.

On a sector basis, energy was the big story in the stock market in 2005. Energy surged for the second straight year, leading all sectors and posting a 29% gain despite a decline of nearly 8% in the fourth quarter. Many of the larger exploration and production companies faltered toward the end of the year. Utilities finished as the second-best sector of the year, posting a 13% gain. Telecommunications services and consumer discretionary stocks posted losses for the year of 9% and 7%, respectively.

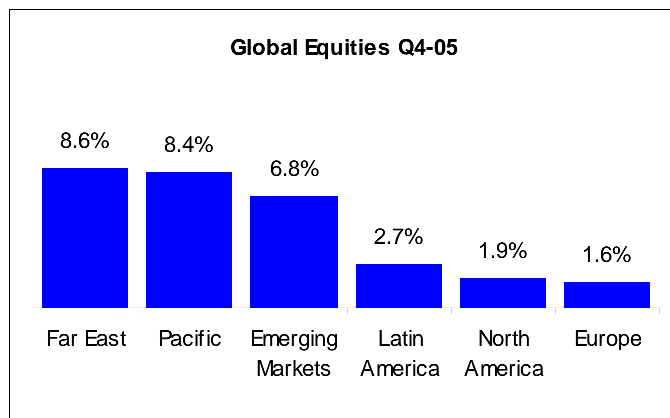
2005 will reside in that middle ground between bull and bear market years, with stock returns below their long-term average but still better than both the fixed-income alternatives and the inflation rate. On balance, the bull market that began in October 2002, though somewhat the worse for wear in the third year, appeared to be intact as 2005 came to a close.

In 2005, bonds all but defied gravity. Though the Federal Reserve raised the fed funds -rate target by two percentage points, to 4.25% from 2.25%, and two of the world's largest issuers of corporate debt, General Motors Corp. and Ford Motor Co., had their credit ratings downgraded to "junk" from investment grade, bond prices stayed high and yields low. The yield on the 10-year Treasury note, the foundation for long-term interest rates, ended the year at 4.39%, compared with 4.22% at the end of 2004. The average spread on high-yield corporate bonds -- the extra interest a company pays over and above that paid by the U.S. government on its bonds -- widened slightly to 3.65 percentage points, compared with 3.10 percentage points at the end of 2004, and a five-year average of 6.22 percentage points.

In line with our expectations, the U.S. investment grade bond market returned 2.4% in 2005, as foreign investors continued to find value in U.S. Treasury securities. Although Fed Chairman Alan Greenspan, who is set to retire at the end of this month, expected long-term interest rates to rise more than they did, that they didn’t is testimony to the market’s belief that, energy aside, the Fed has stayed ahead of the inflation curve. That is, the Fed’s increased credibility as inflation fighter kept bond investors from rushing for the exits as the short end of the yield curve climbed. That’s no conundrum, really, and if the market’s faith is vindicated during 2006 by the achievement of a stable core inflation rate of less than 2.5% (making it 14 years in a row under 2.5%), bond returns can be expected to be closer to their long-term 5% norm in the coming year. China (and global competition generally) suggests to us that the pursuit of productivity, with its benign effects on inflation, will remain the defining characteristic of the post-2001 economic expansion.

The bond market sent out some troubling signals in the last week of the year, with long-term interest rates falling below short-term rates -- a trend that has often, but not always, presaged economic downturns. Most economists don't see a recession coming, but in any case the situation can be tough on banks, hedge funds and high-yield, or junk, bonds.

Foreign Financial Markets



Foreign stock markets enjoyed one of their broader rallies in recent memory, beating their U.S. counterparts during the fourth quarter to score a third straight U.S.-beating year and attracting record sums of U.S. capital.

Global economic conditions last year were close to ideal for stocks. Low interest rates world-wide generated a wave of borrowing and investment. European and Japanese companies continued to restructure, squeezing out bigger profits and boosting their share prices. Emerging markets in Asia benefited from strong economic growth led by China, while Latin American commodity producers capitalized on rising prices for natural resources.

Unlike 2002 to 2004, when a weakening dollar made most foreign stock returns higher when converted into the U.S. currency, last year the strengthening dollar reduced many gains. Still, the latest data from the Treasury Department showed that 2005 was a record year for foreign-stock purchases by American investors, who were on pace for net purchases exceeding $100 billion.

Asian stock markets rose in the fourth quarter as foreigners invested in the region and shrugged off early concerns about rising U.S. interest rates, lofty oil prices and the threat that bird flu might infect humans. The MSCI Pacific index rose 8.4% during the fourth quarter lifted by the region's big winners: South Korea (+15%), Japan and Indonesia (+12%) and India (+8%). Japanese equities rallied during the second half of the year as the economy came out of recession. Japan is a big consumer of raw materials from Asia and a large exporter to the region, both factors leading to the country's sustainable turnaround. In local currency, Japanese equities finished the year ahead by a whopping 43%.

The most widely anticipated event of the year was China's upward revaluation of the yuan. Economists had warned that a stronger yuan, by making Chinese exports less competitive, could prompt a jarring slowdown in China's economic growth. Instead, in July, China allowed the yuan to gain a slight 2.1% against the dollar, causing little impact on Asia's stock markets. Still, the move was significant. Global investors expect Beijing to gradually revalue the yuan upward in 2006 and the years ahead. On the initial-public-offering front, Chinese companies raised a record sum. China Construction Bank, one of China's four big state-owned banks to pursue a public stock offering, raised about $8 billion on the Hong Kong market in the world's largest IPO. A spate of private-sector Chinese enterprises also sold shares in Hong Kong.

In Europe, stock markets shook off sluggish economic growth, an election stalemate in Germany, and the French and Dutch rejection of the European Union constitution to turn in another solid quarter and full-year in local currency terms. The appreciation of the U.S. dollar during the fourth quarter minimized returns to investors in Europe. The MSCI Europe index gained nearly 2% for the past three months and more than 6% for 2005 in U.S. dollars. Conversely, the index gained 4% and 22% in Euro-terms.

On a single country basis in Europe, Austria, Denmark and Norway had better than 20% returns for the year while Ireland, Italy and Portugal suffered declines. In general, European companies were doing what U.S. companies did in the 1990s. They applied technology and cost cutting efforts to become more efficient. For

example, Siemens AG (the German manufacturing conglomerate) cut costs by closing some of its less profitable operations and moving others to Eastern Europe to save costs.

Emerging markets continued to shine during the fourth quarter as global investors increased their exposure to the developing world, believing that many countries had made fundamental improvements, such as cutting their deficits and improving their corporate disclosure requirements since the late 1990s crisis period. Turkey, the Philippines, Colombia had double-digit gains in the fourth quarter while Russia, Jordan and Egypt returned more than 50% for full year 2005.

Our Southern neighbors benefited from improving fiscal and macroeconomic policies. The MSCI Latin America index gained nearly 5% in the fourth quarter to post a return of 45% for 2005 in U.S. dollar terms. Brazil and Mexico were among the strongest performers soaring 50% and 45%, respectively. Healthy demand from U.S. and other international investors more willing to stomach risk in Latin America in light of the lackluster returns of the U.S. stock market, helped drive regional gains. U.S. investors got an extra bonus as Latin American currencies strengthened against the U.S. dollar, boosting returns in dollar terms. The Brazilian real and the Mexican peso were among the world's best performers against the U.S. dollar last year.

Interestingly, at the start of 2005, investors fretted over what might happen to Latin American markets if China allowed its currency to strengthen against the U.S. dollar. The conventional wisdom was that such a move would pull investment dollars out of Latin America and toward Asia, undermining regional stock markets. When the slight revaluation happened in July, Latin American markets declined briefly, but recovered quickly as international investors rushed in and searched for bargains.

Conclusions

While the detail of the GDP and personal income and spending reports – in particular the fact that motor vehicle sales in October were 25% below July's peak – suggests that Q4 economic growth may interrupt the recent strong showing, we think chances are good that the U.S. economy will produce close to trend growth (3.5%) in 2006. This expectation is grounded in the positive order trends being exhibited in manufacturing and services and assumes three things: (1) that the Bernanke Fed leaves the fed funds rate below 5% (vs. 4.25% currently); (2) that long-term interest rates don't have too much further to rise (which also means that the housing sector should hold up reasonably well); (3) and that oil prices trace a determined, if irregular, path lower. (To some degree, oil and interest rates serve as limiting factors for the U.S. economy in 2006: if the economy is tending toward too-fast growth, higher interest rates and energy costs will tend to slow things down and vice versa).

As in 2004, stock P/E multiples contracted by roughly 10% during 2005, limiting the S&P 500's total return to just under 5% (vs. 11% in 2004 and 29% in 2003), only about half the market's long-term rate of return. The 2005 stock market did keep most investors ahead of inflation and ahead of bond returns, but it's a matter of semantics whether to call 2005 a neutral market based on large cap stock performance or an extension of the 2003-04 bull market. Taking a cue from corporate profits, which increased an estimated 13% in 2005, one is inclined to say that the bull market is still extant as 2006 begins. If, as in 1995 (when the Fed brought to a close its last 300 basis-point increase in interest rates), Fed tightening is about to end, investors should be more willing to pay 15 times earnings (or more) for stocks – provided those earnings are continuing to grow and inflation and interest rates start to move lower. On the other hand, P/E's may continue to contract (as they did in the late 1970s) if oil prices rebound and inflation pressures begin to cast a wider shadow or, alternately, if the Fed overshoots the intended soft landing and recession looms. Neither of these less-than-benign outcomes is our expectation at this time, the modest inversion of the Treasury yield curve at year-end 2005 notwithstanding.

The forward market is currently pricing in a 4% to 5% return for bonds in 2006, which looks quite reasonable to us. Based on forecast earnings growth of 8%-9%, relatively modest dividend yields (near 2% currently) and a return of some stability in P/E multiples, stock returns could approach their long-term normal range of 10%-11% in 2006. This anticipated 5%-6% risk premium in stocks over bonds supports our preference for equities.

Another fact supporting our preference for equities in 2006 is the trend toward equity buyouts that supported the markets in the 1980s. Four key factors are driving the trend: (1) Cash-rich private equity buyout firms have increased their appetite for public equities; (2) Sarbanes Oxley, an onerous set of regulations that make corporate management personally responsible for their public filings, is making the push to go private more attractive; (3) Corporate balance sheets, brimming with cash, make many companies attractive buyout targets; and (4) debt financing is easy. Willing investors, ready lenders and motivated sellers are creating an ideal buyout scenario. Private equity firms favor stable businesses with strong free cash flow. It's a trend worth watching in the year to come.

Some risks to watch out for in 2006 include a slowing in the real estate market, Washington's continued high spending levels and related budget deficits, and the potential for further interest rate increases from the Fed. The market currently expects very little in the way of additional monetary tightening from the Bernanke-led Fed, although no one knows how the new Fed chairman will behave once he takes over for Alan Greenspan on February 1st.

Another inflationary force, originating out of Washington, is the tendency of Congress and the Bush Administration to throw money at every problem that comes along no matter how well the economy is doing. The President has yet to exercise his veto power, and one senses that the new Medicare plan is as unwieldy as it is expensive. The rescission of the infamous "bridge to nowhere" from this fall's pork spending does at least hint at the beginning of some fiscal discipline. Moreover, the prevailing conventional wisdom that the Democrats will put in a good showing in the midterm elections next November could be proven wrong if Bush continues to move government out of the way of the free-enterprise capitalist economy while strengthening after-tax rewards for work and investment.

One cannot completely forget about an energy shortage when considering the risks for the year ahead. But, it is highly unlikely that the oil belt will get a rerun of last year's hundred-year storms in 2006. What's more, the high prices of 2005 – which forecasters at ExxonMobil say are not supported by fundamentals – will promote conservation, the development of marginally producing wells, and advances in alternative fuels. If oil prices behave better in 2006, that would boost personal income and GDP, and CPI headline inflation should come in below the core CPI, which we believe will remain under control. In other words, lower oil prices would go a long way toward producing the right economic backdrop for higher, more normal returns for stocks and bonds in 2006.

Lastly, renewed acts of terrorism or other exogenous events can always temporarily derail the financial markets. Rather than looking back wistfully to the past, we prefer to be thankful for the present and excited about the future.

Another of my Yogi Berra favorites: "The future ain't what it used to be."

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